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Authenticity of Islamic Finance in Light of the Principle of *Daman*

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INTRODUCTION

Islamic finance is perhaps the most important peaceful attempt to revive Islamic law in the contemporary world. It has recently gained even more importance as some of the underlying causes of the current global financial crisis, such as excessive lending, securitization of debt, and inaccurate credit ratings, have drawn attention to certain characteristics of Islamic finance as an ethically based system, especially its restrictions on speculation and the sale of debt.[2] However, Islamic finance is still more important for its potentialities than its actual practices. There seem to be several indications that Islamic finance itself is undergoing a critical transition, at the very beginning of its young life. There are in fact serious disagreements and a general lack of standardization regarding some major modes of Islamic finance, disputes of the genuineness of its transactions before the courts, and general uncertainty about its authenticity.

First of all, there are serious fundamental disagreements among scholars on several basic issues of contemporary Islamic finance. These disagreements are far from academic, as they have become stumbling

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[2] See, e.g, the Vatican publication quoted in Aamir A. Rehman, "The Relevance of Islamic Finance Principles to the Global Financial Crisis," Discussion Paper for the Harvard Islamic Finance Project Panel Discussion on the Evolution of the Global Financial System from the Current Crisis, March 16, 2009, p. 1.

blocks to standardization. They center upon the legality of some major modes of Islamic finance, such as *ijara muntahiya bi-tamlik* (purchase and lease-back ending in transfer of ownership),[3] and, most of all, *tawarruq* (monetization; cash seeking; liquidity raising; commodity *murabaha*).[4] As we shall see below, the authenticity of such modes of finance may seriously be called into question.

Secondly, the authenticity of Islamic finance is increasingly disputed before the courts. For instance, in the now famous case of *Beximco Pharmaceuticals v. Shamil Bank of Bahrain*, the English Court of Appeal upheld a judgment for an Islamic bank but only on the grounds that the governing law of the contracts at issue was English law. The *shari'a* issue at stake was the legality of certain contracts and the transactions implementing them from a *shari'a* standpoint, as it was argued before the court that "the transactions were intended to serve as disguised interest-bearing working capital loans."[5] However, the court only addressed itself to issues of English law as the governing law, and the *shari'a* legality of the Islamic finance transactions in question was left open to doubt.

Likewise, in *Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems NV & Ors*,[6] the court disregarded arguments

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[3] On "purchase and lease back ending in ownership" as "usurious (*ribawi*) *hila*" and its applications in some types of *sukuk*, see Nazih Hammad, "*Ijarat al-Ain li-man Ba'aha,*" paper delivered at Al Rajhi Banking and Investment Corporation Fourth Juristic Forum Proceedings, 17 December 2003, pp. 9–15.

[4] See on *tawarruq*: Frank Vogel and Samuel Hayes, *Islamic Law and Finance*, The Hague: Kluwer Law International 1998, pp. 102, 141–143. *Tawarruq*, as currently practiced by Islamic banks, has been declared unlawful by the Fiqh Academy of the Muslim World League in its 17th Session convened from 19 to 23/10/1424h. Also in its 19th Session (from 22 to 27/10/1428h (8 November 2007)) the Academy has confirmed the unlawfulness of "reverse *tawarruq*," i.e., when the Islamic bank itself is the purchaser in the *tawarruq* transaction.

[5] Antony Dutton, "Appeal Brings Certainty to Islamic Financial Investments," *MEED,* 12–18 March 2004, p. 8. See also, Nicholos H. D. Foster, "Islamic Finance Law as an Emergent Legal System," *Arab Law Quarterly* 21, 2007, p. 172 n.9 and the references cited therein.

[6] 13th February 2002, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm Ct). See Kilian Bälz, "A *Murabaha* Transaction in an English Court," *Islamic Law and Society*, 11(1), 2004, p. 125: "delivery of goods is not a prerequisite to recovery by the seller of the relevant installments of the sale price from the purchaser because the agreement is no orthodox contract of sale"; p.126: "the allocation of risk under the contract at hand

based on references to *shari'a* in the agreements under dispute and upheld the agreements as valid under English Law. The *shari'a* arguments centered upon the defense of non-delivery of goods (a defense obviously relevant to any genuine sale contract!) and the argument that liquidated damages in the agreements were "thinly disguised interest." However, the court rejected both arguments on the grounds that the agreement in question was "no orthodox contract of sale." As in the *Beximco* case, the court avoided *shari'a* issues, as irrelevant to the governing law, but the authenticity of the *shari'a* transactions was again left in doubt. Ironically, it was the fact that both the *Beximco* and the *Symphony* judgments disregarded *shari'a*-related arguments that prepared the way for ruling in both cases in favor of the Islamic financiers. The refusal of Western common-law based courts to recognize or factor in *shari'a* considerations is understandable. However, the point remains that the authenticity of Islamic finance was seriously disputed in both cases.[7]

Thirdly, there seems to be general uncertainty about the authenticity of Islamic finance in principle. Some individual prominent '*ulama* even voice their criticism of contemporary Islamic finance as a whole, rejecting in principle any necessity for an independent Islamic finance system.[8]

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reflects a widespread practice in Islamic finance, through which the *murabaha* . . . is effectively turned into a credit vehicle with *autonomous* payment obligations," i.e., irrespective of the defense of non-delivery; p. 132: "the transaction, explicitly labeled a *murabaha* agreement, in effectively construed as a financing agreement with *abstract* payment obligations." Emphasis added.

[7] In some other cases Islamic finance transactions were openly held to be fictitious. Such cases were in particular brought in recent years in the United Arab Emirates. An *Amr Sami* (Emiri Order) of 27 February 1995 had banned bank loans without adequate securities. Several Islamic financing facilities (*murabahas*) allegedly advanced without sufficient securities were characterized as "loans" on the grounds of formalism, and claims for recovery by Islamic banks were accordingly rejected. See, for example, the United Arab Emirates Federal Supreme Court's ruling in Commercial Cassation Lawsuit No. 259-Judicial Year 27 (17 October 2006), where a *murabaha* contract was held to be a fictitious (*suri*) contract hiding a loan transaction.

[8] See e.g., interview with the Rector of Al-Azhar, Shaikh Tantawi, in *Al-Watan* newspaper, Kuwait, 24 May 2007: "there is no difference between the Islamic banks and all the conventional banks." For more details, especially on the so-called "fixed profit rate *fatwa*s." See also Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*, Cambridge University Press, 2006, p. 139; see also the recent joint *fatwa* of most of the senior *muftis* of Pakistan

It will be argued below that the authenticity of contemporary Islamic finance is called into question because of its use of *hiyal* (plural of *hila*, i.e., stratagem, artifice, device, or ruse). Following a discussion of the various implementations of *hiyal* in contemporary Islamic finance, it will further be argued that the dominance of *hiyal* in contemporary Islamic finance is due to casuistic legal methodologies and aversion to reasoning in light of general legal principles (*maqasid al-Shari'a*). An inductive survey of some basic rules of the Islamic law of financial transactions (*fiqh al-mu'amalat*) as it relates to the major modes of Islamic finance would bring into focus the principle of *daman* ("contractual liability") as one of the most fundamental principles of the law. Interestingly, the use of *hiyal* in contemporary Islamic finance is apparently an attempt to substitute them for the principle of *daman*. As we shall see in detail, some times the *hiyal* are used to implement the principle of *daman*, albeit indirectly, but at some other times they are used to evade it. The whole Islamic finance system seems to revolve around the principle of *daman* as the primary criterion of legality.

The general principles of the law, such as the principle of *daman*, form the connecting link between "metalegal" (ethical and socio-economic) values and specific legal rules.[9] Ethical and socio-economic values are often difficult to relate to specific legal rules. For instance, the link may sometimes be difficult to see between the Qur'anic ethical injunction against exploitation and unjust enrichment (e.g., Qur'an: II:

(signed by more then 30 *muftis*) on the unlawfulness of the contemporary system of Islamic banking, available at: http://www.thenews.com.pk/daily_details.asp?id=132723 and http://www.al-inaam.com, (last visited on May 19, 2009). See also Haidar Ala Hamoudi, "Jurisprudential Schizophrenia: On Form and Function in Islamic Finance," *Chicago Journal of International Law*, 7(2), Winter 2007, pp. 605-622; Timur Kuran, *Islam and Mammon: The Economic Predicaments of Islamism*, Princeton: Princeton University Press, 2004; Mohammad Fadel, "*Riba*, Efficiency, and Prudential Regulations: Preliminary Thoughts," available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1115875, (last visited on 19 May 2009); Lawrence Freeborn, "*Shari'ah* and Banking: Compatible or Unsuitable?" *Islamic Horizon,* January–March 2008, pp. 10–12; Tarek El Diwany, "Islamic Banking Isn't Islamic," available at: www.islamic-finance.com/item 100-f.htm.

[9] See, e.g., Peter Stein and John Shand, *Legal Values in Western Society*, Edinburgh: Edinburgh University Press, 1984, p. 258: "Legal principles are the meeting-point of rules and values."

188) and some cases of interest taking, as the risk of exploitation is not always evident in such cases. However, as we shall see in detail later, interest taking involves *daman* ("contractual liability") on the part of the borrower to repay the principal and the interest without a corresponding *daman* (like that of the seller, for example) on the part of the lender. On the other hand, when underlying tangible assets are required for the purposes of some modes of Islamic finance, this is not necessarily to evade the ban on interest taking, as sometimes conjectured by some critics, but primarily to implement the principle of *daman*, as shall also be seen below in more detail. It also follows that any imbalance of liabilities is unlawful even if unlawful *daman* is disguised as a lawful one, as *tawarruq* ("liquidity raising") is disguised as sale, as we shall see below in detail.

THE SPREAD OF LEGAL STRATAGEMS (*HIYAL*)[10]

Normally, legal fiction is a technique occasionally used to adjust the law to practice when the gap starts to widen between the law and social realities. Examples of such useful legal fiction are *fiction de droit* or *présomption de droit* in the civil law system.[11] In Islamic law, such techniques are recognized as *makharij* or *hiyal mashru'a* ("lawful *hiyal*") in contrast to *hiyal ghayr mashru'a*, *madhmuma*, or *fasida* ("unlawful *hiyal*," "blameworthy tricks"). The first type of *hiyal* is supposed to facilitate the functioning of the legal system, the latter is devised to circumvent it.

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[10] See on *hiyal* in general: Joseph Schacht*, An Introduction to Islamic Law,* Oxford: Clorendon Press, 1964, pp. 78–84; Noel J. *Coulson*, *A History of Islamic Law,* Edinburgh: Edinburgh University Press, 1994, pp. 100, 139–141; Vogel and Hayes, *Islamic Law and Finance*, pp. 39–41, 143, 183; Wael Hallaq, *A History of Islamic Legal Theories,* Cambridge: Cambridge University Press, 1997, pp. 173, 185–187; *Al Mawsu'a Al-Fiqhiyya,* Kuwait: Ministry of Awqaf and Islamic Affairs, 1996, art. "*Makharij al-Hiyal*"; Abdurrahman Habil, "The Tension between Legal Values and Formalism in Contemporary Islamic Finance," in *Integrating Islamic Finance into the Mainstream: Regulation, Standardization and Transparency*, ed. S. Nazim Ali, Cambridge, MA: Harvard Law School, 2007, pp. 109–118.

[11] On legal techniques in French law in general, see François Gény, *Science et Technique en Droit Privé Postif,* Paris: Sirey, 1921, Part III. See also Lon Fuller, *Legal Fictions*, Stanford: Stanford University Press, 1967, passim.

However, whether lawful are not, when *hiyal* dominates the legal scene, they may become alarming signs of a juridical predicament. They may be symptoms of intellectual incoherence, simplistic reasoning, and preoccupation with the form at the cost of substance. Besides, once the *hila* box is opened, there is no guarantee that only lawful *hiyal* will be employed, as all types of evasive devices can gradually creep into the system until the benign *hiyal* is hardly distinguishable from the destructive one.[12]

Be that as it may, the disagreements and the uncertainty surrounding the authenticity of contemporary Islamic finance may be chiefly due to its heavy reliance on *hiyal*. By their very nature, *hiyal* are a major source of disputes and uncertainty. Their dominance in contemporary Islamic finance is evidenced by the phenomena of (1) prearrangements, (2) the undisclosed intentions of the parties, and (3) the complex structures and the multiple documentation.

Prearrangements (*Tawatu', Muwata'a*)

Prearrangements play a central role in several products of Islamic finance and are the first indication of the dominance of *hiayl*. Chief among these are promises, involvement of third parties, agency, and special purpose vehicles.

Contemporary Islamic finance's heavy reliance on the device of promises is evident, for instance, in *murabaha* (sale with an agreed-upon profit markup on the cost), which is inconceivable without promises. The customer must first make a binding promise before the financier can purchase the goods. Some financial institutions have attempted to deemphasize the importance of promises in small deals such as motor vehicle finance by prearrangements with the vehicle dealers or by setting up their own dealerships, but a great role is still left for promises to play in any large *murabaha.*

In *ijara* (lease) the lessor (the financier) must promise to sell (or donate) the leased asset at the end of the lease (call option). The lessee (the customer), in his turn, usually promises to purchase the leased

[12] See Fuller, *Legal Fictions*, p. vii: "the fiction represents the pathology of the law. When all goes well and established legal rules encompass neatly the social life they are intended to regulate, there is little occasion for fictions. . . Only when legal reasoning falters and reaches out clumsily for help do we realize what a complex undertaking the law is."

asset upon certain termination events (put option). Such promises are considered "unilateral," albeit binding, and kept separate from each other and from the main lease document as far as possible. They are not considered incompatible with the contracts of sale or lease (*shart munaf li-muqtada al-'aqd*).[13] However, the lease contract is most often preceded by a sale contract between the customer himself and the financial institution, as the leased asset is usually an asset originally owned by the customer (the would-be lessee) and sold to the financial institution (the would-be lessor) to provide an object (asset) for the contract of lease. It may be difficult to see how a binding promise by the purchaser to sell back the purchased asset and a binding promise by the seller to purchase it back may be compatible with the contract of sale and its most important legal outcome of the transfer of ownership. The very fact that the *ijara* in such transactions is called *ijara muntahiya bi-tamlik* ("lease ending in transfer of ownership to the lessee") indicates that the initial sale from the would-be lessee to the would-be lessor is structured as a "temporary" sale, which is incompatible with the concept of sale itself.[14]

In addition to promises, involvement of third parties is another essential prearrangement in contemporary Islamic finance. An Islamic bank cannot deal directly with its customers without prearrangements with a third party in the two major finance modes of *murabaha* (markup sale) and *istisna'* (commissioned manufacture). The third party is either a supplier of goods, as in *murabaha*, or a contractor or manufacturer, as in *istisna'*. This reveals the simple fact that the Islamic bank is not originally a trader or a contractor. A trader or manufacturer would usually deal with its customers without the mediation of a third party.[15]

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[13] See *al-Ma'ayir al-Shar'iyya*, Manama: Accounting and Auditing Organization of the Islamic Financial Institutions, 2007, pp. 415–432.

[14] The promise (or the undertaking) of the issuer or manager of *sukuk* (*shari'a*-compliant bonds) to purchase back the *sukuk* assets or to redeem the *sukuk* at maturity or upon default at nominal value is also one of the major issues in *sukuk* structure. It is clear that such a promise is a device of risk shifting to evade redemption of the *sukuk* at the market price. See, e.g., Muhammad Taqi Usmani, "*Sukuk* and Their Contemporary Applications," pp. 3, 7–11, available at: www.failaka.com/downloads/Usmani_SukukApplications.pdf, (last visited on 19 May 2009).

[15] In addition to the two above mentioned types of prearrangements, the device of agency has an important role in several products of Islamic finance, e.g., in *murabaha*, *tawarruq*, and *ijara* (see below). Another widespread form of

The Undisclosed Intention of the Parties

The second indication of the dominance of *hiyal* is the undisclosed intention of the parties in several finance transactions. A financier would normally act as *rabb al-mal* ("finance provider"). A financial institution may only assume the role of trader, manufacturer, or a real estate developer under the guise of *hila*.[16] In *murabaha,* for example, the Islamic bank acquires the goods before selling them to the customer. Likewise, in *istisna'* the Islamic bank orders the asset to be manufactured before delivering it to the customer. However, in both instances the true intention is obviously credit sale, not simply trade or manufacture. The true trader or manufacturer is the original supplier between whom and the customer the bank mediates as a financer.

The Complex Structures and the Multiple Documentation (*Al-uqud Al-murakkaba*)[17]

Another indication of the spread of *hiyal* is the phenomenon of complex structures and multiple documentation. *Murabaha* (markup sale) more or less starts with an order and promise to purchase from the customer to the bank, followed by purchase of the goods by the bank from a third party supplier (often through the customer's own agency in large deals), and ending in sale of the goods by the bank to the customer. Agency from the customer to the bank to sell the goods on behalf of customer is used in the in case of *tawarruq.*

Itisna' (commissioned manufacture) is invariably accompanied by *istisna' muwaz* (back-to-back *istisna'*), whereas an *istisna'* contract is signed between the customer and the bank and an *istisna'* (or

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prearrangement are the special purpose vehicles (SPVs), which are a mainstay of *sukuk*. See, e.g., El Gamal, *Islamic Finance*, pp. 21, 23.

[16] On the point that *shari'a* boards and *fiqh* councils have allowed some financing deals which were closer to *hiyal* than to genuine Islamic finance when Islamic banks were few in number and undergoing difficult circumstances, see Usmani, "*Sukuk* and Their Contemporary Applications," p. 13.

[17] On the medieval legal ruse of the *contractum trinius* used by European merchants in the Middle Ages to circumvent the ban on usury and lend at fixed rate, see J. J.Henning, "The Mediaeval *Contractum Trinius* and the Law of Partnership," *Fundamina*, 13(2), 2007.

muqawala) contract between the bank and the contractor along with a design and supervision contract between the bank and the consultant.

Ijara (lease) is also characterized by complexity and multiplicity of documentation, as the bank purchases the asset (often from the customer himself) and leases it to the customer. The bank promises to sell the asset back to customer upon discharge of liability. Service agency is signed between the bank and the customer, to shift responsibility for insurance and maintenance to the customer on behalf of the bank. Transfer of ownership from bank to customer takes place upon payment of liability.

Tawarruq* as an Illustration of *Hila[18]

The above-mentioned three indications of *hila* are best illustrated by *tawarruq* (monetization; cash seeking; liquidity raising; commodity *murabaha*). Prearrangements (*tawatu'*) take place between a bank and two brokers: the first broker arranges for the purchase of commodities by the bank, the second broker arranges for the purchase of the same commodities from the bank as an agent of the customer after the latter purchases them from the bank. The two brokers are necessarily affiliated; usually one of them is a subsidiary of the other. The customer promises to purchase the commodities as soon as they are purchased by the bank. The three devices of *tawatu'* (promises, third parties, and agency) are thus utilized in *tawarruq*.

The intention of the parties in *tawarruq* is invariably the cash and never the purchase or sale of commodities. No commodities are changing hands and no payments are made to the supplier or the first broker or by the second broker or any ultimate purchaser, as only book entries (and brokerage) are at work, and the ultimate outcome is the cash received by the customer from the bank. The paperwork is absolutely irrelevant to the intention of the parties.

The structural and documentational complexity is also most evident in *tawarruq*. As can be easily seen, no less than six steps are involved in every single transaction, not to count preexisting master agreements between the bank and the two brokers and between the latter two themselves.

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[18] On *tawarruq* as *hila*, see Husain Hamid Hassan, "*Mura'at al-Maqasid al-Shar'iyya wa Ma'alat al-Af'al fi –A'mal Al-Masarif al-Islamiyaa*," Albaraka Seminar, 2007, p. 138.

MAQASID AL-SHARI'A AND "THE GENERAL PRINCIPLES OF THE LAW"[19]

The dominance of legal stratagems in contemporary Islamic finance, and consequently its conceptual predicament and the doubts surrounding its authenticity, may be mainly due to its casuistic legal methodologies and its aversion to reasoning in light of general principles.[20]

However, the problem is further compounded by the lack of any developed system of general principles in Islamic law. Despite genuine attempts by several eminent scholars, research in *maqasid al-shari'a* (the "aims of the law," Islamic legal theory, the general principles of Islamic law) is almost in its infancy when compared to writings on *usul al-fiqh* (methods of derivation of the Law) and on *qiyas* (analogical reasoning) in particular. In Islamic legal theory, legal rules are essentially derived through the methodology of *qiyas*, and particularly through the process of *takhrij al-manat* or *takhrij al-'illa* (derivation of the ratio legis; *manat* in this context is in the same sense of *'illa*, ratio legis). One of the main characteristics of the *'illa* is its being *mundabita* (objectively verifiable). This means that an acceptable *'illa* cannot vary from one situation to another or from one person to another. The classical example of *'illa mundabita* is traveling as the ratio legis of

[19] See on *maqasid* in general, Ibrahim bin Musa al-Shatibi, *Al-Muwafaqat*, Cairo: al-Maktaba al-Tijariyya al-Kubra, 1994; Muhammad al-Tahir Ibn 'Ashur, *Maqasid Al-Shari'a Al-Islamiyaa,* Amman: Dar al-Nafa'is, 2001; Ahmad Al-Raisuni, *Nazariyyat al-Maqasid'ind al-Imam al-Shatibi,* 4th edition, Riyad: Al-Dar al-'Alamiyya li'l-Kitab al-Islami, 1995; Izz al-Din Ibn Zughaiba, *Maqasid al-Shari'a al-Khassa bi'l-Tasarrufat al-Maliyya,* Dubai: Markaz Jum 'a Al-Majid, 2001; Yusuf Hamid Al-Alim, *Al-Maqasid al-'Amma li'l- Shari'a al-Islamiyya,* 2nd edition, Riyad: Al-Dar al-'Alamiyya li'l-Kitab al-Islami, 1994. On the general principles and "internal structure" of Islamic contract and commercial law, see Frank E. Vogel, "Ijtihad in Islamic Finance," in *Proceeding of the Fifth Harvard University Forum on Islamic Finance*, Cambridge, Harvard University, 2003, p. 122.

[20] See on casuistry, Schacht, *An Introduction to Islamic Law*, pp.150, 205–206; Vogel and Hayes, *Islamic Law and Finance*, pp. 42–43; Vogel, "Ijtihad," pp. 121–122; Baben Johansen, "Casuistry: Between Legal Concepts and Social Praxis," *Islamic Law and Society* 2, 1995, pp. 135–156. Despite the apparent casuistic nature of Islamic law, its underlying general principles indicating "internal logic and structure," albeit often unarticulated, may be recognized without difficulty. See Vogel, "Ijtihad," pp.121–122.

shortening the quadruple canonical prayers and breaking the fast in the month of Ramadan. Only a traveler may enjoy this *rukhsa* (license). Although the "wisdom" (*hikma*) or the "benefit" (*maslaha*) behind this license is obviously the alleviation of the hardship of travel, the wisdom or the benefit by itself is not an acceptable *'illa*, because it is not *mundabita* as it varies from one situation to another and from one individual to another. Although details on the minimum distance and the maximum period of time relevant to this license differ from one school to another, traveling remains an objectively verifiable situation, while hardship for the non-traveler is not an acceptable *'illa* for prayer shortening or fast breaking, even if the hardship for a particular non-traveling individual in a particular situation may be much greater than the hardship, if any, encountered by "a king traveling in luxury." As in every legal system, a line must be drawn to achieve uniformity and applicability despite some marginal cases of apparent unfairness.[21]

Maqasid al-shari'a, literally translated as "aims of the Law," do not yet enjoy the same degree of objective verifiability of the '*illa* of *qiyas*. Despite the general agreement that *maqasid al-shari'a*, whether in the form of general "aims," general "principles," or general theoretical foundations of the law, do exist, scholars are often suspicious of their applicability in any objective, practical manner like that of the '*illa* of *qiyas*. That is because the *maqasid* are still formulated as very general, abstract rubrics such as *hifz al-din* (protection of religion), *hifz al-nafs*, (protection of life), *hifz al-mal* (protection of wealth), *hifz al-nasl* or *al-ird* (protection of family or honor), and *hifz al-aql* (protection of intellect), these five values being the so-called five necessities (*al-daruriyyat al-khams*). Obviously, when it comes to practical issues such as prayer and fasting on a journey, for example, one cannot draw much from the broad and vague rubric of *hifz al-nafs*.

Having said that, one of the practical approaches to *maqasid al-shari'a* may be to tackle them as "General Principles of the Law." One of the methods of derivation of *maqasid* is *istiqra*' (inductive reasoning). If it is shown by induction that a certain identical principle underlies each individual legal rule in a certain body of rules, could such a principle be one of the *maqasid al-shari'a*, i.e., one of the

[21] See on *qiyas*, Hallaq, *A History of Islamic Legal Theories*, pp. 83–107. As far as one can see, the central issue of the objective verifiability (*indibatiyya*) of the *'illa* of *qiyas* is nowhere emphasized in this book.

General Principles of the Law? That is the argument to be tested in the following pages in relation to the contemporary Islamic law of finance.

INDUCTIVE SURVEY OF SOME BASIC PRINCIPLES OF ISLAMIC FINANCE

"God has allowed sale and forbidden *riba*."[22] Why is sale allowed and *riba* forbidden? To tackle this millennium-old question, let us start by a quick survey of the basic rules characterizing the law of financial transactions (*fiqh al-mu'amalat*) insofar as it relates to the major modes of Islamic finance.[23]

Mudaraba (Capital-Management Partnership):

Liability of the *mudarib* (the manager-partner) for the *mudaraba* capital or the profit is not acceptable, absent negligence or misconduct. In other words, the unacceptability of *daman* (liability, guarantee, assumption of risk) on the part of the *mudarib* seems to be the most basic rule underlying *mudaraba* in Islamic law. Third party guarantee of the profit in favor of the capital provider is not permissible for the same reason, as security in such a case would be enjoyed by the capital provider only.

Sharika (Partnership)

A partner cannot be held liable for his partner's share or profit. Exclusion of the partner's *daman* appears to be the dominant rule in any partnership. Third party guarantee of the profit in favor of one partner is likewise unacceptable.

[22] Quran: 2:275.

[23] For more details on the contracts and concepts discussed below, see the relevant articles in al-Mawsu'a al-Fiqhiyya, the relevant standards in *al-Ma'ayir al-Shar'iyya*, the relevant sections in Vogel and Hayes, *Islamic Law and Finance*, and Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Karachi: Idaratul Ma'arif, 1999.

Wakala (Agency)

Absent negligence or misconduct, the *wakil* (agent) in investment *wakala* is not liable for the amounts he invests on behalf of the *muwakkil* (principal) nor for the expected profit therefrom. In other words, there is no *daman* (liability) on the *wakil* without negligence or misconduct. Otherwise, *daman* by the *wakil* would render the *wakala* practically indistinguishable from a guaranteed loan.

Kafala (Suretyship, Guarantee)

Consideration for *kafala* is illegal.[24] For instance, if a benevolent loan is guaranteed by a third party for a consideration, then the loan will be practically rendered interest-bearing if the guarantee is called. Moreover, an issue of *gharar* (uncertainty, speculation) may be here involved, as the surety would receive the consideration without a corresponding definitive liability on his part, as we shall see below in the discussion of *gharar* and concomitant issues.

Ijara (Lease)

The lessee's *daman* for loss of the leased asset (absent negligence or misconduct) is illegal. Accordingly, maintenance and insurance, even in the case of capital lease ending in ownership, are the responsibilities of the lessor. That is why Islamic financial institutions resort to the device of service agency to shift the liability for maintenance and insurance to the lessee. However, the law is clear that *daman* of the leased asset is on the lessor and only *daman* of the rent should be assumed by the lessee.

Bay' (Sale)

The seller's liability (*daman*) for defects (*daman al-'aib*) and vindication (*daman al-istihqaq*, *daman al-istirdad*, *daman al-darak*,

[24] See, e.g., Proceedings of Abu Dhabi Islamic Bank Seminar on the Letter of Guarantee, Abu Dhabi, November 11, 2000, p. 106.

third party claims) counterbalances the purchaser's *daman* to pay the price.[25]

Riba (Usury)

Prohibition of *riba* seems to revolve around the principle of (contractual) *daman*. For instance, interest on credit is unlawful in view of the *daman* on the part of the borrower to pay back principal and interest, without a corresponding *daman* on the part of the lender.

Gharar (Uncertainty, Speculation)

The issue of *daman* seems also to underline the prohibition of *gharar*. For instance, in the sale of the "stray camel," the seller offers no *daman* for defects or third-party claims, or even for deliverability, whereas the purchaser is liable for the price. Moreover, the "stray camel," perhaps analogous to some contemporary speculative financial instruments, would never be sold at a fair price, when the ultimate outcome is accounted for. If such "camel" is later found, the seller would be at a great disadvantage. If it is never found, the purchaser is obviously the loser.[26] The whole deal is defective due to the lack of balance of *daman*.

The above-mentioned rules, being among the most basic in the Islamic law of financial transactions, seem to be dominated by the principle of *daman* (liability, contractual liability).[27] A transaction is

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[25] *Daman al-darak* is the *Hanafi* term for vindication. *Daman al-'uhda* includes both defects and vindication in the *Shafi'i* and *Hanbali* terminology. See *Al-Mawsu'a al-Fiqhiyya*, art. *Daman*, pp. 273, 311.

[26] See, e.g., Abdul Razzaq al-Sanhuri, *Masadir al-Haqq-fi'l-Fiqh al-Islami*, Beirut: Dar Ihya' al-Turath al-'Arabi, 1997, vol. 3, pp. 31–39.

[27] The rules relating to *daman* are prominent in the literature of *qawa'id* ("general rules," often translated as "maxims"). Many of the *qawa'id* may actually be "maxims" but there are certain genuine general principles among them, such as *al-kharaj bi-daman* ("profit goes with liability") and *al-ghurm bi-ghunm* (loss, i.e., liability, goes with gain). See Ibn Nujaim, *al-Ashbah wa'l-Naza'ir*, pp. 127–128; al-Suyuti, *al-Ashbah wa'l-Naza'ir*, pp. 295–296; Baz, *Sharh al-Majalla,* pp. 56–58. See on *qawa'id* in general, Vogel, "Ijtihad," pp.121–122; Vogel and Hayes, *Islamic Law and Finance*, pp. 35, 72. See also Hassan, *Mura'at al-Maqasid*, p. 99. Although some of the *qawa'id* may appear to be in conflict or rather, overlapping, with some others, the principal

acceptable as long as "justified *daman*" is there and no "unjustified *daman*" is involved. *Riba* and *gharar* are disallowed because of unjustified *daman*, e.g., liability on the part of the borrower in *riba* and on the part of the purchaser in *gharar* without a corresponding liability on the part of the lender or the seller. The presence of justified *daman* and the absence of unjustified *daman* in every transaction excludes both *riba* and *gharar*.

Getting back to the question of why sale is lawful and *riba* is not, the lawfulness of sale (including a premium over cash in credit sale) seems to be due to the justified liability of the seller for defects and third-part claims to counterbalance the purchaser's liability to pay the price. *Riba* is unlawful because of the unjustified liability of the borrower to pay back both principal and interest without a corresponding liability on the part of the lender (in contrast to liability of the seller for defects and third party claims or liability of the lessor as regards the leased asset). Generally speaking, *daman* seems to be a *shart* (prerequisite) in sale and lease, and a *mani'* (invalidating element) in *mudaraba* and partnership, and, most importantly, in interest-bearing loans.

AUTHENTICITY OF ISLAMIC FINANCE IN LIGHT OF THE PRINCIPLE OF *DAMAN*

If it is admitted that the Islamic law of financial transactions is underlined by some coherent structure of essential principles, then the principle of contractual liability (*daman*), as illustrated in the preceding pages, is perhaps one of those principles. A quick review of the major modes of contemporary Islamic finance in light of this principle may now be in order.

Murabaha for the Purchase Orderer

The legality of *murabaha* for the purchase orderer (*murabaha li'l-amir bi'l-shira'*) is usually justified in contemporary Islamic finance jurisprudence by the existence of *daman*. However, what is meant by *daman* in this case is basically a pre-sale *daman* (*daman al-yadd*) that is different from the concept of contractual *daman* (*daman al-'aqd*)

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ones among them, such as the mentioned *al-kharaj bi-daman*, may represent important general principles rather than just "maxims."

explained above.[28] A "pre-sale *daman*" means "risk of loss" or "risk of ownership" or "liability of the owner for loss" arising from the mere fact of ownership. According to this view, the Islamic bank is only required to purchase the goods and "bring them under its *daman*" before selling them to the customer. This widely accepted argument, that the pre-sale "liability for loss" is the only *daman* required in *murabaha* to justify the profit and exclude *riba*, seems to emphasize risk for the sake of risk as it overlooks the fact that such liability is of no practical significance inasmuch as no counterparty is drawing any benefit from such liability or risk. This argument also seems to mistake an issue of *gharar* for one of *riba*. Pre-sale *daman* may exclude *"bay' ma laysa 'indak*" (selling what you do not have) but not "*ribh ma lam yadman*" (profit from what one is not liable for), as stated in the well-known Prophetic saying.[29] The *daman* that justifies the profit in sale cannot be the pre-sale *daman* that is irrelevant to the sale itself, but rather the contractual *daman* arising from the sale transaction.

Be that as it may, the contractual *daman* does exist in *murabaha* and may still serve as justification for this product. Although the pre-sale *daman* is the declared justification for *murabaha*, the fact that the sold goods are usually the intended subject of sale entails actual contractual *daman* on the part of the Islamic financial institution. Despite the fact that such institution is actually a financier, it does act as a seller, liable for defects (unless such liability is legally excludable) and third-party claims. The *hila* underlying *murabaha* for the purchase orderer is therefore a "lawful *hila*," as it requires the existence of the underlying tangible assets necessary for *daman*, and is thus closer to legal fiction in the positive sense than it is to evasive artifices. This is, of course, subject to the condition that the goods are actually intended to be acquired by the customer so that the contractual *daman* is not deliberately circumvented, as we have seen and shall see more below in the case of *tawarruq*. In other words, a *hila* in *murabaha* may still be a lawful *hila as long as the object of the sale financing is actually the object of the contract,* and is therefore under *daman* for defects and third party claims.

[28] See *Al Mawsu'a Al-Fiqhiyya,* art. *Daman*, p. 258: *yadd al-malik*: "the owner is liable (*damin*) for what he owns and is under his control."
[29] See, e.g., Muhammad b. Isma'il al-San'ani, *Subul al-Salam,* Beirut: Al-Maktaba al-'Asriyya, 2003, vol. 3, pp. 27–28.

Back-to-Back *Istisna'*

As in *murabaha* for the purchase orderer, the rationale behind the back-to-back *istisn'* in contemporary Islamic finance jurisprudence is the same concept of "ownership risk." The Islamic bank orders the asset to be manufactured or constructed by a specialized contractor before delivering it to the customer so that the asset "is brought into the *daman*" of the bank to justify the profit of financing. However, as just argued above in the case of *murabaha*, the justification for the legality of the back-to-back *istisna'* should not be sought in the pre-sale "owner risk" but in the contractual *daman* arising from the *istisna'* sale itself. It follows that, as in *murabaha* for the purchase orderer, *istisna'* ends up in contractual *daman as long as the manufactured asset is actually the intended object of the contract*, and may therefore be considered a "lawful *hila*."

***Ijara* (Purchase-Lease-Sell)**

The *ijara* artifice is perhaps the most "lawful *hila*."[30] That is because the contractual *daman* created by *hila* in sales such as *murabaha* and *istisna'* can be transitory, whereas utilization of the leased asset and consequently the liability of the lessor therefor normally coincide with the tenor of the facility. Although the supplementary device of "service agency" shifts the liability to the lessee as "agent" of the lessor for the purposes of maintenance and insurance, the lessor remains liable for total destruction of the leased asset as long as the *ijara* would be terminated in such event.

However, the *ijara* rental payments, including the profit embedded therein, are justified by contractual *daman* only when utilization of the leased asset by the customer is the actual intention of the parties, such as when the asset is originally purchased by the bank from a third party, or in the case of forward lease when construction of the asset is financed by the bank. Otherwise, the *ijara* would turn into an "*ijara tawarruq*" as we shall see below. In short, the *hila* of *ijara* may be a "lawful *hila*" *as long as the object of the lease agreement (i.e., the leased asset) is the true object of the financing facility* and is accordingly under *daman*.

[30] On purchase and lease as a "lawful *hila*" (or *makhraj*, solution), see Hammad, *"Ijarat al-Ain li-man Ba'aha*," p. 8.

Murabaha Tawarruq

Confusion between pre-sale *daman* and post-sale *daman* is at the heart of the problem of *tawarruq*. Insistence on the pre-sale *daman*, or the "owner liability" has inevitably paved the road to *tawarruq*. As long as the commodity "has been brought into the bank's *daman,*" the argument goes, the transaction is lawful from the *shari'a* standpoint. This argument overlooks the fact that the so-called ownership by the bank may in the case of *tawarruq* be so fictional and transitory that it may last for no longer than a few minutes and the fact that the so-called "ownership risk," if it exists here at all, is irrelevant as far as the sale of the commodity to the customer is concerned. The seller's pre-sale "ownership risk" can never convincingly justify the profit charged by the bank for *tawarruq* since the purchaser draws no benefit whatsoever from this risk. *Tawarruq* is therefore often confused with interest-taking since (1) cash is the real subject of contract; (2) the customer is liable for payment of the cash plus profit margin; and, (3) the customer's liability is as unjustifiable as that of an interest-bearing loan's borrower, as the liability for the principal and the profit is not counterbalanced by any liability of the bank. In other words, the net result of *tawarruq* is the "unjustified *daman*" on the part of the customer and the absence of "justified *daman*" on the part of the bank, as the commodity is immediately sold on behalf of the customer. The customer has no interest in the commodity, which is only superimposed by the bank to maintain some pretense of *daman*. When the test of *"object of financing must be object of contract"* is applied to *tawarruq*, it becomes evident that the object of the financing facility is the raising of cash liquidity, which is never disclosed in the *tawarruq* agreement itself, as the declared object of this agreement is the sale and purchase of commodities. The true object of the facility is not covered by *daman*. *Tawarruq* is a *hila*, and of very doubtful legality at that.

"*Ijara Tawarruq*" (Purchase–Lease Back–Sell Back)

It may be objected that *tawarruq* is not conceivable in *ijara* as the lease usually coincides with the tenor of the facility and the leased asset remains subject to *daman* for the same period. However, as already argued above, *daman* of the leased asset is relevant to *the object of the facility* only if the leased asset is the actual object of the facility, as in forward lease or when the asset is first purchased by the bank from a third party. If the asset is actually purchased by the bank from the

customer then leased back to him, the lease ultimately ending in sale-back of the same asset to the same customer, then a totally different product is at hand. Obviously, such a transaction is devised to provide the customer with cash liquidity (*tawarruq*) and the lease is only superimposed as an attempt to create *daman*. It is true that *daman* does exist here, contrary to the *murabaha tawarruq*, but is nevertheless purely fictitious, as the object of the facility is the cash, not the leased asset, and the cash is not covered by any *daman*. Contrary to forward lease and purchase-and-lease, purchase-and-lease-back does not even rise to the level of "lawful *hila*" but is simply a variation of *tawarruq*.[31]

CONCLUSION

The authenticity of contemporary Islamic finance cannot be meaningfully discussed in the absence of any agreed-upon general principles of Islamic finance law. Experience has showed that the two concepts of *riba* and *gharar* may be too broad to form any solid basis for agreement. This is evident from (1) the lack of standardization and the current disagreements on the legality of some major modes of Islamic finance; (2) the increasing disputes of authenticity of Islamic finance before the courts; and, (3) the widespread uncertainty about the authenticity of contemporary Islamic finance in general.

The disputes and the uncertainty surrounding the authenticity of contemporary Islamic finance may be chiefly due to its heavy reliance on the casuistic technique of legal stratagem, or *hila*, instead of general principles. One of the best approaches to the issue of authenticity of Islamic finance may therefore be from the *hila* standpoint. Upon careful analysis, the major current controversies of Islamic finance are at heart disagreements on *hila*, that is, whether this or that product is lawful or unlawful *hila*, e.g., whether *tawarruq* is an acceptable application of *murabaha* financing, *murabaha* financing itself being essentially *hila*.

The general principle of *daman* seems to underly several basic rules of the Islamic law of financial transactions (*fiqh al-mu'amalat*). When major modes of contemporary Islamic finance are examined in light of this principle, some of them turn out to be applications of lawful *hila* (or *makharij shar'iyaa)* as they tend to create some

[31] On "purchase and lease back ending in ownership" as "usurious (*ribawi*) *hila*" and its applications in some types of *sukuk*, see Hammad, "*Ijarat al-Ain*," pp. 9–15.

"justifiable *daman,*" and some turn out to be products of unlawful *hila*, as they lack "justifiable *daman*" and represent transformations of "unjustifiable *daman*." The above-suggested test of *"object of financing must be object of contract"* demonstrates the centrality of the concept of *daman* in Islamic finance. Whenever the object of the financing facility is actually the object of the contract, the requirement of *daman* is somehow fulfilled, as in the lawful *hiyal* of *murabaha* for the purchase orderer, back-to-back-*istisna'*, and the simple purchase-lease-sell *ijara*. If the true object of the financing transaction is not the actual object of the contract, then only unlawful *hila* is at work, as the underlying purpose of the transaction is to circumvent *daman*, such as in *murabaha tawarruq* and "*ijara tawarruq*." With the exception of *mudaraba* and investment *wakala*, where no immediate underlying tangible assets are required at the time of contracting and no *hila* is therefore needed, all other major modes of contemporary Islamic finance seem to fall under lawful *hila* or unlawful *hila*.

The authenticity of Islamic finance may be restored if the issue of *hila* is brought out into the open and lawful *hila* is transparently distinguished from unlawful *hila*.